AIMA

RSM

In Harmony

How hedge funds and investors continue to strike the right note in aligning their interests

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Contents

Foreword

We are pleased to present AIMA's latest research, 'In Harmony – how hedge funds and investors continue to strike the right note in aligning their interests'. Three years after the 'In Concert' paper was published, this new research paper builds on those findings. It examines to what extent these trends are continuing, as well as identifying how hedge funds and investors are aligning interests that best meet their mutual needs.

Assets under management for the hedge fund industry continue to break new records, as it attracts an increasing number of institutional investors. Their views and expectations of hedge funds have brought about significant changes impacting the overall industry. In the simplest terms, this revolution centres on three Cs – customisation, collaboration and communication.

The industry's institutional, experienced and sophisticated investor base has driven the change towards bespoke investment mandates, value advisory services – and deeper partnerships that now create a closer alignment of investors' and hedge-fund managers' interests.

Our analysis reveals that investors and managers are exploring new approaches to negotiate fees and fund terms, and that hurdle rates are more widespread. The widespread use of the '2 and 20' compensation model is now consigned to the past and we have observed increased use of 'tiered fees' for investors. A new equilibrium in the alignment of interests is on the horizon.

Customisation and co-investing mean hedge-fund managers can now deliver solutions that meet their investors' specific risk and return goals. This trend has been accompanied by a recognition of the value of accurate and informed communication between investor and manager, allowing for a productive exchange of knowledge between both parties and an increased understanding of investment strategies by investors.

We would like to thank AIMA's research committee[1] and the representatives of AIMA's global investor steering committee[2] for their valuable input and for taking the time to discuss these findings. We would also like to thank the various managers who provided the number of testimonials included throughout this paper.

Finally, we thank you for your time in reading this paper. We hope you enjoy it.

Jonathan Waterman
National Asset Management leader, RSM US

Tom Kehoe
Global Head of Research and Communications, AIMA

1 A global committee comprising hedge-fund managers, consultants and representatives from the academic community. It produces and endorses research and thought leadership on all aspects of the hedge fund business model.

2 Members of this global committee represent pension fund managers, sovereign wealth funds, endowments, foundations, large family offices, and private banking platforms.

Executive Summary

The findings from this year's survey are based not only on what is current practice between hedge funds and investors, but also potential future developments and how these could be best implemented.

Below are the **six** key takeaways that emerged from this year's survey:

1. Moving towards a new equilibrium

There is an increasing sense that fund fees and terms between hedge-fund managers and their investors are moving towards a new normal. No longer is the focus solely on fees, rather investors and hedge funds are continuously exploring new ways to negotiate fees and fund terms to reflect a better alignment of interest. Managers are responding to investors' needs by putting in place arrangements that are more closely aligned both to the requirements of the client and the underlying investment strategy. Fund hurdle rates continue to grow in popularity. Almost 40% of all respondents use fund hurdle rates of varying description, including a pre-agreed alpha hurdle rate, used by 14% of the total number of respondents.

2. Beyond 2 and 20

In recent years, investors and managers have agreed on a variety of new flexible fund fee structures. No longer is it only the case that hedge-fund managers charge the traditional 2 and 20 flat fee structure. Rather than merely reducing the headline fee, hedge-fund managers are examining more equitable compensation arrangements that are beneficial to them and their investors. An emerging trend from this year's study is tiered fees for investors; as the hedge fund firm grows its assets under management, investors will benefit from a lower fee. 35% of all respondents offer this fee discount to investors.

When it comes to reconciling the most appropriate fee structure being charged to investors, between 20% to 30% of the alpha earned being paid to the hedge fund feels about right. Our discussions with managers and investors reveal a shared belief that the manager share of any alpha earned should be about one third, with the remainder going to the investor.

3. From manager-led products to investor-led solutions

The hedge-fund manager-led product of the past is being replaced with more bespoke investment mandates including co-investment, customised solutions and other value advisory services which best aligns investors' unique risk and return goals.

Over half of all respondents believe that customised solutions are crucial to driving closer alignment with their investors, a marked increase from the 14% of respondents who offered the same view in our 2016 study.

Hedge-fund investors are now considering co-investing; a popular arrangement with private equity institutional investors. Almost one in five respondents are offering co-investment opportunities, while one in two are open to exploring ways to do this with their investors.

4. Skin in the game

Having 'skin in the game' remains the most important demonstration of alignment between hedge-fund managers and investors, as voted by 76% of all respondents. At the founding stage it is not uncommon for fund founders/principals to invest as much as 80% of their capital.

Investors still value hedge-fund managers having 'skin in the game' and are still discerning of fees, but now partner with them far more to create bespoke investment solutions through increased transparency, better communication and a responsiveness to investor needs.

5. Sharing the expense

The variety and amount of expense that must be incurred to operate a hedge fund business is increasingly challenging for hedge funds. Investors globally are increasingly sensitive not just to the compensation fee to be paid to the hedge-fund manager, but also to the total costs incurred operating a hedge fund. The findings from this year's research point to a clear delineation regarding what the hedge fund firm pays and what expenses are paid by its investors (the fund). Hedge-fund managers work with investors to place a cap on any additional expense burden from one-off costs or expenses incurred from launching a new business.

6. Partnering with investors

Both hedge funds and investors stand to benefit from a closer and more aligned partnership. We see the advantages as three-fold. First, as the investor builds more knowledge about the hedge-fund manager, they gain a deeper understanding of how the hedge fund will behave. This will help to avoid short termism that can damage fund performance. Second, the deepening partnership between the hedge-fund manager and investor enables the investor to take advantage of the hedge-fund manager's unique market insights benefitting their overall portfolio. Third, this closer collaboration can help to deliver new products and services. This is demonstrated by the increased interest in hedge funds developing more bespoke investor solutions and other value advisory services.

Methodology

1. Hedge-fund manager survey with input from 118 hedge-fund managers (*referenced as respondents throughout the paper*) globally representing approximately $440billion in assets under management (AUM)[3]. For simplicity, the use of hedge funds and hedge-fund managers are used interchangeably throughout.

2. In depth roundtable discussion and one-to-one interviews with hedge funds to improve understanding of the key findings from the manager survey. Throughout this report, you will see several testimonials from hedge-fund managers who participated in various roundtable discussions.

3. Input from a global investor steering committee which manages more than $1trillion in AUM and allocates approximately $100billion in AUM to hedge funds.

4. Input from a relevant thought leadership and external research across various hedge fund industry stakeholders. These include investors, hedge-fund managers, hedge fund industry service providers and policymakers.

Demographic of respondents

Figure 1: Main strategy of the flagship fund

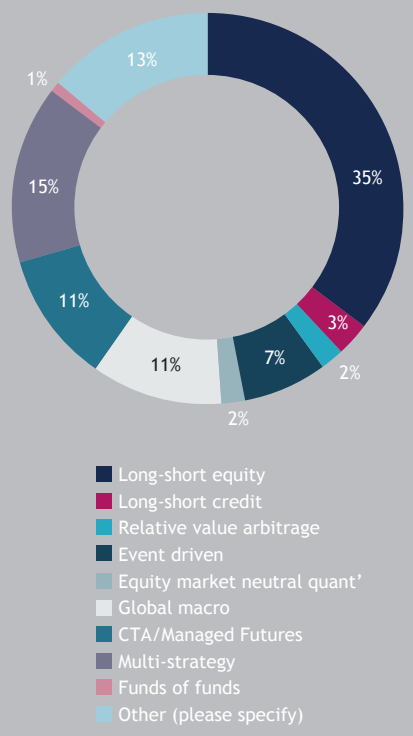
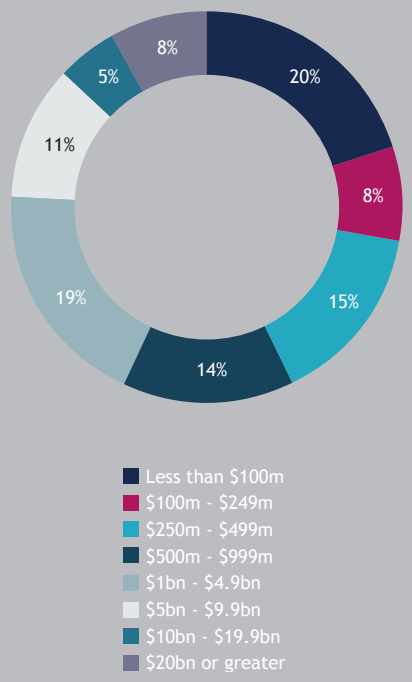


Figure 2: What is the net asset value (in US$) of hedge fund assets under management of your firm?



3 Charts included in the paper represent the number of responses from either the entire population that completed the survey or relevant to the number of responses that elected to respond to a question.

1 Partnering with investors.

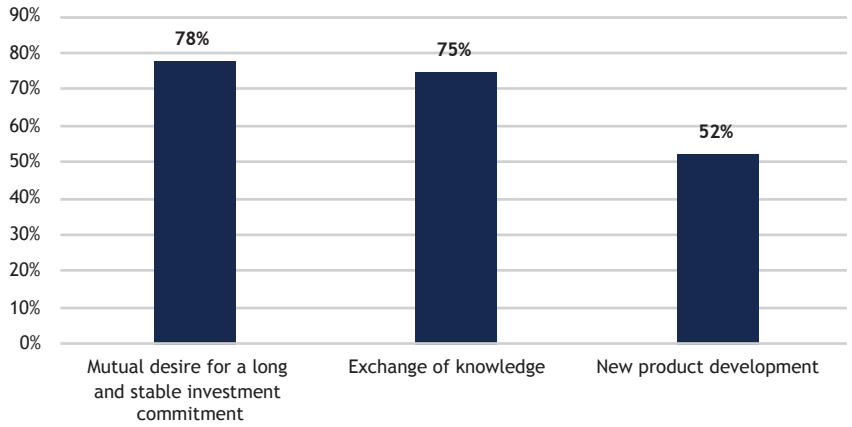
A quiet revolution is taking place across the hedge fund industry. The findings from this survey point to hedge funds and investors breaking new ground in their quest to strike the perfect partnership.

As the hedge fund industry becomes more institutional and its investors more experienced and sophisticated, the hedge-fund manager-led product universe of the past is being replaced with more bespoke investment mandates, value advisory services and deeper partnerships which best align with the investor's unique risk and return goals.

The key motivations for hedge-fund managers to align interests with investors are as follows:

- A mutual desire for a long and stable investment commitment;
- Better communication and a greater exchange of knowledge;
- New product development.

Figure 3: Other than performance, please rank in order of importance what is most important to you when you consider an alignment of interests between your firm and your investors - top three answers.



1.1 Moving from a manager-driven model to a tailored investor solution

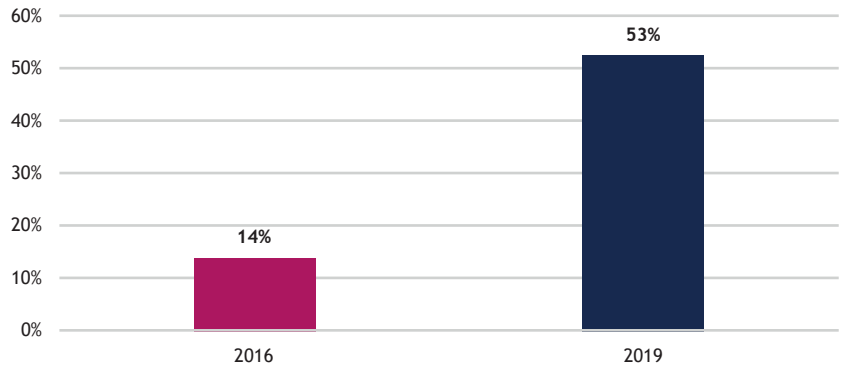
One of the significant transformations of the hedge fund industry in recent years is its evolution from a manager-led to an investor-driven model. This change is characterised by two increasingly popular industry developments.

(i) Customised solutions

Just over half of all hedge fund respondents in our survey cited the use of customised solutions as being an important way to align with their investors. Implementing these solutions ensures that hedge funds can be better tailored to meet an investor's specific risk and return targets precisely and can deepen pre-existing relationships. The two most popular types of fund structures that govern these solutions are the managed account and the fund of one[4].

Just over half of all hedge fund respondents in our survey cited the use of customised solutions as being an important way to align with their investors.

Figure 4: Hedge funds that cite having customised solutions as being an important factor in aligning interests with investors.



Managed accounts enable the investor to give the hedge fund a specific investment mandate and develop a portfolio unique to their specific risk and return appetites. Examples of this arrangement involve investors adjusting their portfolio positions to focus on one niche investment or carve out a more appropriate investment strategy with the hedge fund.

A managed account can also provide significantly enhanced transparency with most arrangements allowing for the fund's positions to be viewed on a live basis with daily reporting. This can improve the investor's understanding precisely how the fund's returns are being generated.

4 A fund of one is an investment structure that has become popular in the fund of funds world. The investor, in this case the FOF, is the sole investor in a specific vehicle or fund.

Why a customised offering is just as important to hedge funds as being able to offer a differentiated product and competitive fees.

"Investors have increasingly specific needs and are looking for hedge funds that can customise their offering in response. In our experience, these needs can be diverse. At the simpler end, investors may wish to tweak the product, so it offers a broadly similar investment process, but better meets their overall mandate by targeting higher risk or offering improved liquidity by removing certain less-liquid strategies. More complicated examples may include wishing to isolate one particular segment of a strategy to include in their overall mandate - for instance, getting Asian exposure only from a global equity long-short provider or focusing on socially responsible investment. Likewise, investors may want the product to be based in a certain jurisdiction.

Ultimately, both hedge funds and investors live in an increasingly complicated world where hedge-fund managers are challenged to produce the best possible outcomes. Hedge-fund managers realise that to ensure their clients succeed, being able to provide a customised offering is just as important as being able to offer a differentiated product and competitive fees."

$10billion + multi-manager

In recent years, the assets under management of managed account platform (MAP) sponsors has grown to reflect the strong level of interest shown by investors. Given the size of some of these MAPS, they can negotiate better incentive fees, and some have even negotiated management-fee only arrangements for its investors.

The scope to negotiate fees within a fund's commingled structure has become more limited in recent years. In contrast, an investor that has a customised solution can achieve significant fund fee reductions over the long term, albeit a more considerable investment is often required at the outset. In comparison to investing in a commingled fund structure, where typically the minimum investment requirement can be as low as $500,000, most customised arrangements are more expensive to access. Anecdotally, it seems some hedge funds require a minimum investment size of $50m before building out a more customised solution.

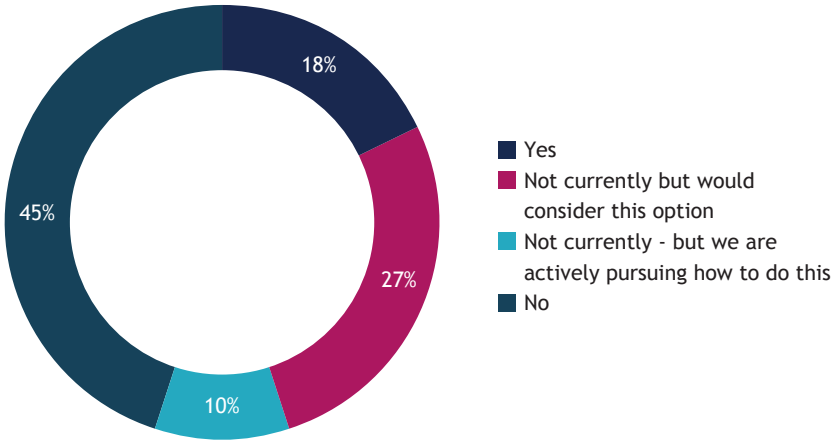
As services like MAPs become popular, the scope for aligning interests through having a customised solution is likely to increase. Managed correctly, this should enhance the ability of fund managers and investors to build more mutually productive partnerships.

(ii) Co-investments

Co-investments are already a popular tool with institutional investors, private equity and real estate managers. Hedge funds are establishing similar arrangements with their investors recognising the mutual benefits of co-investment to generate attractive returns, and better align their interests. In comparison to the 2016 survey[5], the findings of this year's survey suggest that more hedge funds are prepared to co-invest, with **just over half of all respondents are offering co-investment opportunities or open to exploring ways with investors to do so.**

Just over half of all respondents are offering co-investment opportunities or open to exploring ways with investors to do so.

Figure 5: Does your fund(s) offer co-investment opportunities to your investors?



Co-investment arrangements can be a one-time investment opportunity within the scope of the main hedge fund or organised as separate and/or independent co-investment funds. The typical motivations for hedge funds launching these vehicles with investors include:

- Hedge funds are more likely to retain investors and build goodwill with them. Often investors will allocate to a flagship commingled vehicle with an eye toward getting access to a niche co-investment opportunity with the hedge-fund manager.
- Where a hedge fund may only be recognised as being expert in one area, they may opt to co-invest so that they can build a track record of expertise elsewhere.

5 In the 2016 study, 48% of the total number of responses indicated that hedge-fund managers offer, or were considering offering, co-investment opportunities to their investors.

- First-mover advantage can provide the hedge fund with an avenue to help it stand out from its peers; as a versatile partner willing to engage in exciting investment opportunities with its investors.
- Depending on the investment approach, co-investments can be useful in a high conviction investment strategy with investors. For example, a manager may have built a large position in a company within its fund, but the absolute amount represents a relatively small proportion of the outstanding stock of the company. For the manager to build a larger position in the company's stock without breaching risk limits within a fund, but to gain more power when negotiating with management, a co-investment opportunity will be offered to clients.

Figure 6: Do you offer co-investment opportunities to your investors? (by strategy)

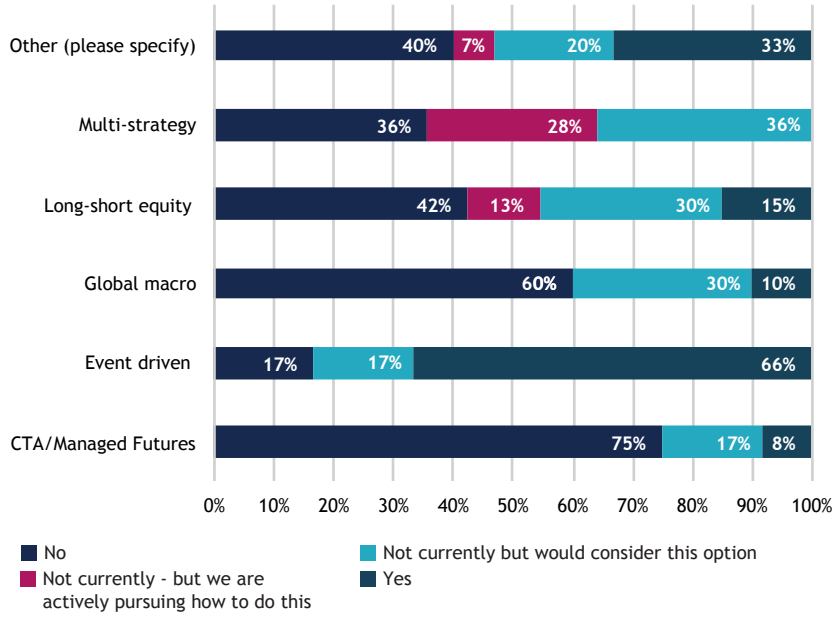
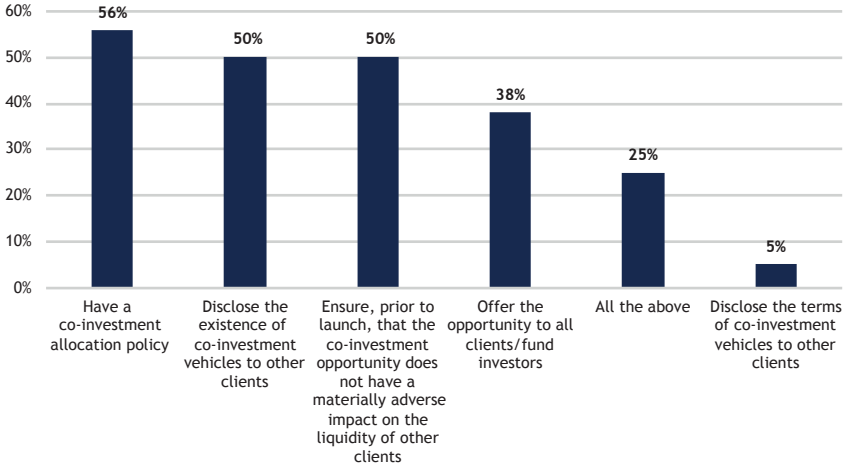


Figure 7: When offering co-investment opportunities, it is important for the hedge fund to (select all that apply).



Typically, opportunities are offered to established investors in the fund. They are often asked to commit a significant investment of capital over a long timeframe. This prevents quick redemptions in the event of the fund incurring losses. In return, management fees charged to investors are negligible or zero, although managers share a proportion of any profits earned.

Any such arrangement with a prospective investor is likely to be the subject of a strict Non-Disclosure Agreement (NDA)[6] with the hedge-fund manager. Recognising the benefit of co-investment opportunities, 18% of respondents offer these arrangements to their investors while a further 27% would consider such an option if requested by investors. The findings of this survey reveal that smaller and emerging hedge funds (below $500m in AUM) and mid-sized funds (with $1billion and $5billion in AUM) are more likely than their larger peers to consider a co-investment with investors[7]. Anecdotally, evidence suggests that larger funds will also agree to such an arrangement, given the right terms.

Given the bespoke nature of co-investments, they are often set up via a segregated structure (fund of one, managed account). This enables investors to have greater transparency and be more actively involved with the hedge fund.

Co-investment at work

"We entered into a co-investment agreement last year with a large investor in one of our pooled funds. This involved an opportunity in a highly liquid company that we saw was being significantly mispriced and where the position was already fully sized in the pooled product. Given the high liquidity of the stock, we felt there was additional capacity to invest in the company and that any arrangement to co-invest would not adversely impact the trading ability of the pooled fund (and therefore would not create a conflict of interest).

Prior to entering into this arrangement, to ensure that we were treating all our clients fairly, we canvassed them to ascertain their willingness or ability to take part in such a co-investment.

The co-investment took the form of a separate managed account where we had full trading discretion and liquidity terms that were not better than the pooled fund. In the end, the co-investment deepened our relationship with the client without it being detrimental to other clients.

We are acutely conscious of the potential for co-investments to create conflicts (as well as align interests). We have therefore put in place a Co-Investment Policy to ensure we consider and prevent any potential conflicts before entering into these arrangements."

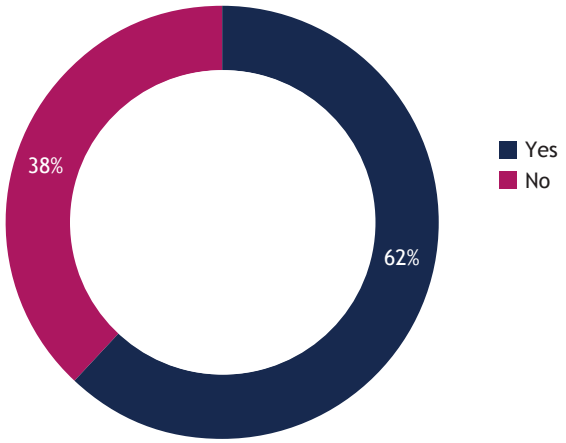
$20billion long-short hedge-fund manager

6 Legal contract between at least two parties that outlines confidential material knowledge or information that the parties wish to share with one another for certain purposes but wish to restrict access to or by third parties. NDAs can be mutual meaning both parties are restricted in their use of the materials provided, or they can restrict the use of the material by a single party.

7 Combined the percentage of emerging and mid-sized managers that would consider a co-investment is 53% of the total population that responded.

(iii) Responsible Investment - Working with investors to do good and do better

Figure 8: Over the past year, have you seen an increase in interest around your firm's responsible investment capabilites from current or prospective investors?



Nearly two thirds of all respondents have seen increased interest in their firm's responsible investment capabilities over the past 12 months

Investors are increasingly demanding that their capital be put towards a more responsible form of investing (RI)[8] that as well as minimising risks and maximising returns, also take environmental, social and governance concerns (ESG) into account.

Nearly two-thirds of all respondents have seen increased interest in their firm's responsible investment capabilities over the past 12 months. This is representative of the strong sentiment we see across the broader hedge fund industry, where ESG and RI is fast becoming one of its most significant considerations.

Certain components of responsible investment are not new to hedge funds. The industry has led the way in pursuing good governance around its investments. Hedge funds have a long history of engaging with the management of the companies in which they invest. The hedge funds that we spoke to report an increase in questions from investors about their RI practices. They may find that by taking small steps, such as becoming an engaged asset owner; they can demonstrate positive practices. Related to that, where a hedge fund teams up with its investor(s), via ownership of a small percentage of a listed company's equity, they can demand the attention of the company's governing bodies and pressure them to improve their ESG practices.

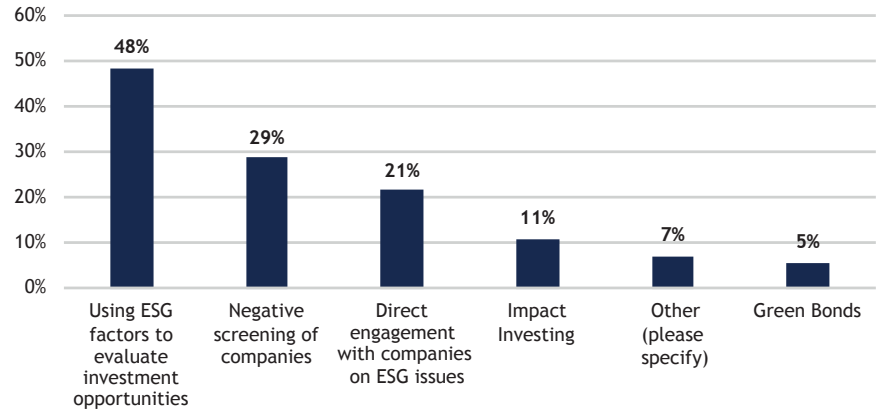
8 Responsible Investment (RI) is a broad term that encompasses a range of choices. At one end of the spectrum, a manager could practice RI simply by screening a handful of securities out of a portfolio. At the other end, a manager could decide to run a fund entirely dedicated to investing in assets that generate social good. For further information on ESG and RI, please see AIMA's Responsible Investment Primer (May 2019), www.aima.org

While some hedge fund strategies may be relatively easy to implement via the deployment of ESG and/or RI, others may be more challenging. The use of segregated accounts can enable more tailored ESG investment portfolios for investors. Examples include more bespoke hedge funds that are invested purely in ESG-friendly companies. Further, an increasing number of hedge funds are implementing a greater ESG focus in their investment approach.

There is a broad differentiation in how hedge fund firms approach responsible investment, with one in two respondents using ESG factors to evaluate investment opportunities. Negative screening continues to be a popular approach, deployed by almost one third of all respondents. There is an on-going debate as to whether negative screening results in a long-lasting social impact on a meaningful scale. One in five respondents say they engage directly with companies on ESG issues while just over one in ten are engaged in impact investing.

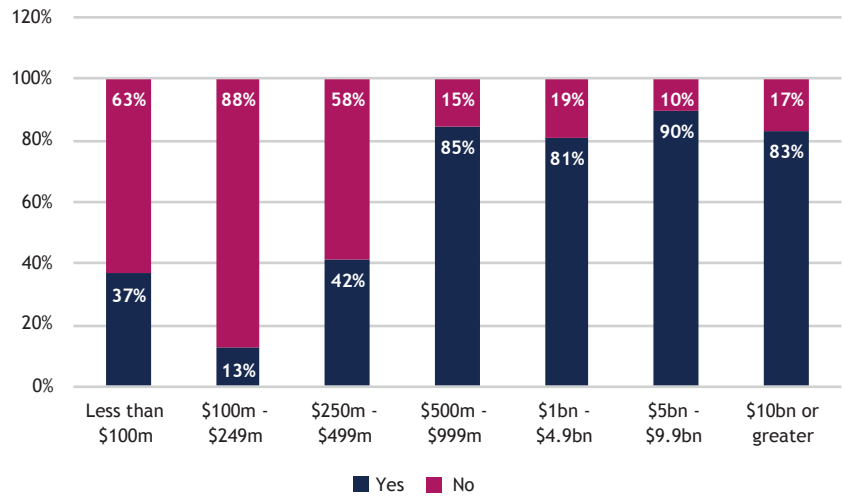
Whatever your view on ESG and RI, a combination of increasing investor demand as well as greater scrutiny from regulators[9] is only likely to increase the appetite for hedge funds to incorporate ESG and RI further.

Figure 9: Which of the following best describes your firm's approach to responsible investing?



9 The European Union is in the process of adopting various sustainable finance measures. This will undoubtedly have an impact on the way that managers operate in the region, and as a result, this topic will continue to grow in importance as those measures are imbedded into investment processes.

Figure 10: Over the past year, have you seen an increase in interest around your firm's responsible investment capabilities from current or prospective investors? (AUM)



1.2 Better communication

Knowledge sharing and client support is a crucial element in any partnership between a hedge fund and its investors. Just as no two managers are the same, not all investor types are the same either. Hedge-fund managers typically welcome closer co-operation with investors in order to understand how best to manage the changing requirements and dynamics of their client base.

Knowledge sharing and client support is a crucial element in any partnership between a hedge fund and its investors.

A small or emerging hedge-fund manager may only need to cater to one or two external investors[10] (typically a fund of hedge funds manager or a family office), whereas an established mid or large-scale fund will typically cater to a much greater variety of investor types and a less concentrated client base. Each investor base will have its own views on what constitutes a successful alignment of interests.

A hedge fund that benefits from regular constructive dialogue with its investors will have a better chance of understanding and reconciling their demands. Doing so, they may be able to satisfy a broader range of investor requirements and thus promote long-term investment and a more stable client base.

Among the larger respondents to this survey, some have worked with their investors to offer secondment opportunities to the investors' employees to improve their understanding of their fund's processes and operations.

10 In this case, external investors do not include friends and family money.

Greater interaction can help explain the performance attribution, the drivers behind the performance and the risk profile of the portfolio. The development of customised research for investors allows a hedge fund to differentiate itself more and increase the value it delivers to its clients. At the same time, hedge funds need to be careful in managing this relationship. Providing investors with highly customised material can be a distraction and a potential drain on the hedge fund's resources to the possible detriment of fund performance.

Investor communication can be further improved by making sure a hedge fund has a high-quality investor relations (IR) function. The IR team needs to have enough depth of knowledge about the fund's investment strategy and a proven ability to communicate in sufficient detail about the fund's performance and field any queries related to the fund's portfolio without having to call on senior investment personnel, taking time away from their primary responsibility of looking after the portfolio. The IR team also has the responsibility to listen and understand the unique needs and expectations of its investors and to communicate this effectively to senior members of the fund to deliver the best solution. As greater transparency is provided, IR professionals can expect to field increasingly detailed and technical questions from investors.

Hedge funds are taking steps to ensure that they are acting on these steps. They are making high-quality hires around investor relations that can deliver the firms expertise and solutions in a coherent fashion to its investors. These roles are structured so that they can act as a nexus between the senior investment personnel of the fund and the investor.

How knowledge sharing can help build deeper partnerships with investors

"Our business and investment strategies have been built on an academic approach to markets. And with strong links to a number of premier universities around the world, our researchers, data scientists and business leaders seek to contribute to the advancement and dissemination of knowledge through active discussion and regularly publishing academic articles.

As a firm, we host more than 50 seminars globally to share our understanding around research and technology, including an Annual Spring Seminar featuring leading industry and academic experts. Our insights have been published in over 100 pieces of academic research, white papers and technical notes available on our website and for investors. We have also developed dynamic visual dashboards focused on complex topics such as identifying principal components to construct optimal portfolios across instruments and asset classes.

Through our active approach to knowledge sharing, we can engage in robust conversation with our investors, helping them develop deeper understanding into our approach. In return, these thoughtful interactions are instrumental in guiding our firm, as we look to provide solutions and deliver investment strategies that truly create value for our investors."

$10billion quantitative hedge-fund manager

1.3 An investor partner willing to invest for the long term

Hedge funds are keen to develop meaningful partnerships with investors that are willing to see beyond any short-term fall in a fund's performance and remain committed to the strategy of the fund. This allows the fund manager to offset the performance volatility in the month to month returns and build a more stable relationship with their investors. A long-term commitment by an investor can also enhance their understanding of the fund's investment process and assessment of the long-term return profile of the funds against the motivating criteria of their overall portfolio.

It's critical for investors to gain insight into risk-adjusted measures of performance in their evaluation of hedge funds. For institutional investors, the ability of a hedge fund to add diversification to the overall investment portfolio and reduce correlation to broad market indices is typically a key consideration in assessing a fund's performance. Metrics that capture the volatility of returns, the correlation of fund returns to an index, or aspects of peak-to-trough value declines (drawdown) are all considered in manager selection. Hedge funds may have specific mandates in terms of the type of securities in which they can invest in (for instance, an ESG mandate as per above).

A fund manager's ability to execute the intended strategy is the key factor in performance evaluation. This may require further discussion with investors so that expectations regarding the risk management and expectation for the fund delivering performance are met on both sides.

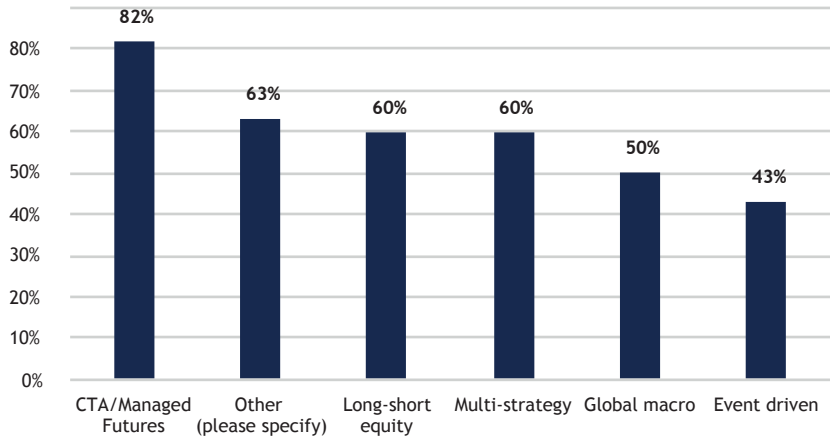
2 Aligning interests outside of fee structures.

2.1 Greater transparency

Investors are increasingly asking for and receiving greater transparency and control of their investment portfolio. All respondents recognise that they are required to provide investors with as much transparency on their fund as is reasonable.

The willingness among hedge funds to provide position level data is closely related to how quickly their fund's portfolio typically turns over (i.e. the more frequent the portfolio turnover, the less risky it is for managers to divulge position level data). On that basis, CTA and managed futures are generally more able to provide this level of transparency. However, for certain hedge fund strategies, position level transparency is not in the best interests of the investor. Rather, it is perfectly acceptable to provide transparency to investors of the fund's positions in an aggregated format.

Figure 11: Hedge funds that believe offering greater transparency to investors can better improve aligment of interests. (by strategy)



Although not as widespread across the hedge fund universe, some of the very large, equity-based hedge-fund managers only provide their long US equity positions (via their 13F filings[11]) to their investors, given the sensitivity that they have to other parties knowing what short positions they hold in their fund.

The increasing variety of fund risk reports that can be requested by an investor has undoubtedly pushed costs higher. This has happened both explicitly, in terms of the amount of capital being invested by the hedge-fund manager in deploying additional risk systems and personnel - and implicitly in the opportunity cost of the hedge-fund manager having to spend time away from its primary business of investing.

11 An SEC quarterly filing required of institutional managers with over $100 million of qualifying assets with relevant long US holdings.

Changes to industry regulations as well as the growing influence from institutional investors and other investor types who allocate to hedge funds have improved transparency and public openness in the hedge fund industry. In the US, the Dodd-Frank Act requires most hedge fund advisers to register with the Securities and Exchange Commission[12]. This results in the public reporting of the basic operations of the fund and any conflicts of interest that may ensue.

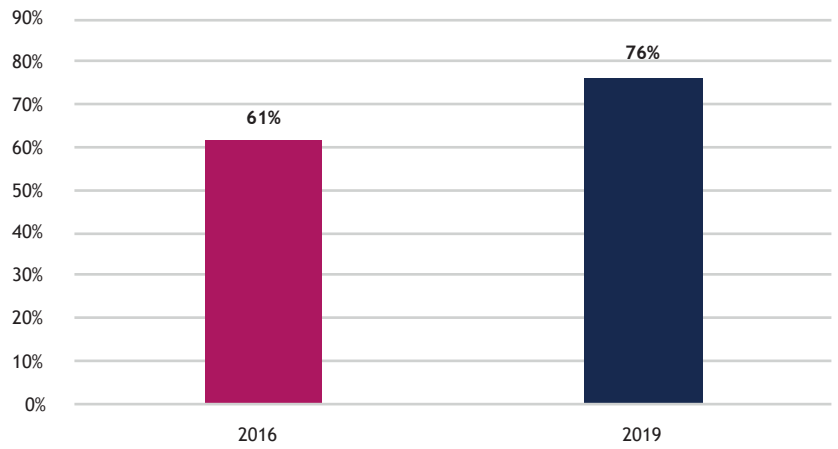
The JOBS Act[13] in the US enables managers to be more ambitious in terms of their engagement with investors and the public. In Europe, the Alternative Investment Fund Managers Directive (AIFMD) enables greater transparency between managers and investors. The on-going 'institutionalisation' of the hedge fund industry and the growing popularity of managed accounts has resulted in a higher level of portfolio transparency provided by the fund manager to the investor.

There must be a balance between investors' demands for complete transparency and what a hedge-fund manager is prepared to offer. Hedge-fund managers may not wish to disclose their strategy's IP or 'secret sauce' which would disadvantage them and their investors. Before making an investment, the hedge-fund manager should agree with their investor the level of ongoing transparency being provided for their fund.

2.2 Holding significant skin in the game

When we asked the respondents how they best describe their way of aligning interest with their investors, 76% of them point to making sure they have significant personal capital invested in the fund. This is an increase on our 2016 finding, where just over 60% of hedge funds polled said the same.

Figure 12: Hedge funds that cite having significant personal capital invested in the fund is the single most important measure to demonstrate true alignment with investors.



76% of all respondents cite having significant personal capital invested in the fund is the single most important measure for true alignment with investors.

12 There is still a large number of fund advisors who are exempt reporting (smaller funds advisors with less than $150m RAUM).

13 Jumpstart our Business Start-ups Act (2012), https://www.sec.gov/spotlight/jobs-act.shtml

The notion of having 'skin in the game' is centuries old. Entrepreneurs place their worldly effects and possessions behind any new ventures that they pursue. To align their interests, investors expect company boards and their investment managers (e.g. fund investment principals) to have a personal investment in the companies which they direct and/or manage. Equity investors like to see that senior executives (including the CEO) of the companies in which they invest hold a significant shareholding, and that any remuneration packages include incentives comprised of stockholdings of the company. Having 'skin in the game' is the single important measure to demonstrate true alignment of interest between the hedge-fund manager and its investor(s) and drives a continual focus on performance.

For hedge funds, this will take the form of the fund's investment principals deploying a meaningful portion of their own personal capital in the funds which they manage. This will ensure that in the event their fund underperforms and loses money for their investors, they would also lose out. However, the way this is implemented is important. It can create conflicts of interest that managers need to avoid. For example, if the hedge-fund manager runs multiple funds and has invested part of its wealth in just one of these funds, there is a risk that they will allocate the best trade ideas to this fund. Therefore, 'skin in the game' needs careful implementation to be beneficial for the hedge-fund manager as well as for all the investors in the fund(s) managed.

One should not forget that performance fees are a simple but effective method of creating hedge fund 'skin in the game'. A performance fee creates an alignment of interest between the investor and the hedge-fund manager in that both profit when the fund performs strongly. Several provisions (which we discuss in the following section) can be put in place to tailor the specifics for this type of arrangement.

Why do you deem skin in the game an important factor in aligning your interests closer with investors?

"The operative description here is being the best possible 'partner' to your investor. I would go further and say skin in the game is crucial. If we wish to attract investors, who will stay with us for the long term, we can't expect them to merely take our word that we would treat their capital as if it was our own, we must demonstrate that fact as well. I would expect any PM to have a substantial portion of their liquid net worth invested in any fund that they manage.

Many investors view the withdrawals of performance fees as redemptions, so I think there must be an obligation to re-invest compensation (of senior members of the manager) in the fund. Consideration must be given for the costs of living (school fees, paying off mortgages etc.) but the expectation must be that manager compensation should be reinvested back into the fund. As a firm, investment principals and firm partners have an obligation to re-invest 75% of their total compensation, once this reaches a certain threshold."

Long-short manager AUM between $500m and $1billion.

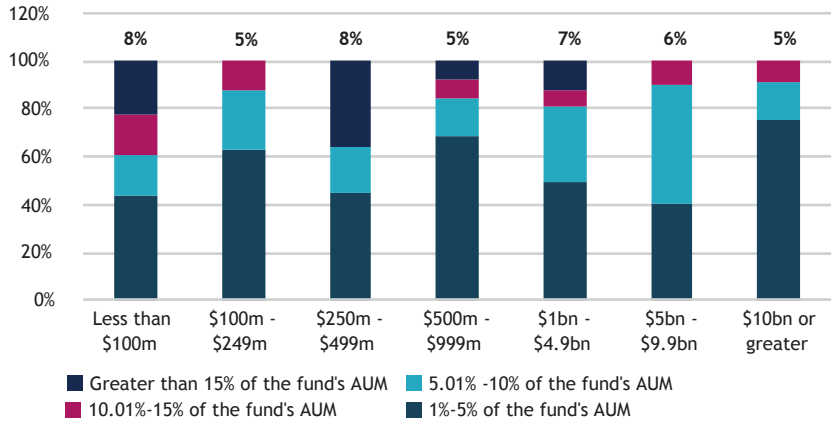
2.3 Appropriate levels of personal capital investment in a hedge fund

It is neither possible (nor appropriate) to offer a blanket rule for the appropriate level of personal investment in hedge funds required by investors. The findings from this survey reveal a significant variation in the levels recorded, especially in relation to the size and the stage of fund development.

The major source of capital invested by an emerging or start-up hedge fund is made up of the founding principals' net worth and from friends, family members or from other personal connections. At this stage, it is not uncommon for founders and principals at funds to have as much as 80% of their personal capital invested in the fund at inception, and throughout its early years. The founder will essentially have unlimited liability with potentially devastating personal consequences if the fund incurs sizeable losses. As a hedge fund increases its AUM and looks to diversify its capital base, the proportion of personal wealth invested will reduce.

Our findings reveal the average proportion of personal investment (*inclusive of employees who are not the founder*) is just over 6% of the funds NAV. It is important to try to understand this evolution and not apply a one-size-fits-all approach. Levels of personal investment will necessarily not be constant across the hedge fund's lifecycle.

Figure 13: To what extent are your principals and employees invested in the fund? (by AUM)



Re-investing fund deferrals/bonuses back into the hedge fund:

Whether as a result of commercial reasons, regulatory changes[14] or investor pressure, hedge-fund managers deferring remuneration has become an increasingly common practice. This helps to guard against the adverse performance associated with key investment talent walking out the door.

Linked with this, it is increasingly becoming the norm for hedge fund employees to invest these deferrals, or their bonuses, into their strategies on a continuing basis. The fact that hedge-fund managers are investing personal wealth in the fund is continuous, rather than an event at the start of the fund, helps to align further the interests of them and their investors.

14 Deferred remuneration is a requirement under the Alternative Investment Fund Managers Directive (AIFMD)

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